UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF NORTH CAROLINA
CHARLOTTE DIVISION

IN RE: **COAL CLINICS, INC.,** Debtor.	Bankruptcy No. 98-32074 (Chapter 7)
NOVACARE ORTHOTICS AND PROSTHETICS EAST, INC., Plaintiff, vs. **SUSAN SOWELL,** in her capacity as Trustee in Bankruptcy for Coal Clinics, Inc., **AND RICHARD GINGRAS,** Defendants.	Adv. No. 99-3036

FILED
U.S. Bankruptcy Court
WDNC, Charlotte, NC
MAR 29 1999
Geraldine Treutelaar Crockett, Clerk
/dbl

JUDGEMENT ENTERED ON MAR 29 1999

ORDER GRANTING PRELIMINARY INJUNCTION

This matter came before the Court on the Verified Motion for Preliminary Injunction filed by Plaintiff NovaCare Orthotics and Prosthetics East, Inc. ("NovaCare"), pursuant to Rule 65 of the Federal Rules of Civil Procedure and Rule 7065 of the Federal Rules of Bankruptcy Procedure. The matter was heard on March 18, 1999.

By stipulation of the parties, the Court received into evidence at the preliminary injunction hearing the September 1997 documents surrounding NovaCare's purchase of assets from Coal Clinics ("Debtor"), the September 30, 1997 Assignment Agreement from Debtor to Defendant Richard Gingras ("Gingras"), and Gingras' December 22, 1998 arbitration demand to the National Health Lawyers

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Association ("NHLA"). Over an objection by Gingras, the Court took judicial notice of the NHLA arbitration rules applicable to the NHLA arbitration proceeding. The Court also took judicial notice of NovaCare's payment of approximately $154,000.00 to the Trustee, which funds are being held pending this Court's disposition of the Trustee's claims to avoid the Debtor's assignment of the Earn-Out Payments to Gingras.

It appears to the Court that preliminary relief is necessary and appropriate under Rule 65 of the Federal Rules of Civil Procedure and Rule 7065 of the Federal Rules of Bankruptcy Procedure as analyzed in A. H. Robins Co., Inc. v. Piccinin, 788 F.2d 994 (4th Cir. 1986). This preliminary relief is necessary in order to maintain the status quo pending the Court's expedited resolution of the Trustee's avoidance complaint as to the Gingras-Coal Clinics assignment agreement.

BACKGROUND

NovaCare and the Debtor entered into a buy-sell agreement effective September 1, 1997, under which NovaCare purchased certain assets and assumed certain liabilities of the Debtor. Under the buy-sell agreement, NovaCare is required to make certain "Earn-Out Payments" to the Debtor when NovaCare's operation of the acquired assets generate net revenues in excess of the Net Revenue Targets for the years 1998, 1999, 2000 and 2001.[1]

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[1] The net revenue targets for 1998 and 1999 are $2,270,000.00, the net revenue target for 2000 is $2,502,000.00 and the net revenue target for 2001 is $2,602,000.00. If the net target is met, there is to be minimally a 92% payout and a maximum 160% payout, which results in a payout for each of the four years between $299,000.00 and $520,000.00.

The buy-sell agreement expressly contemplated that NovaCare and the Debtor would also enter into a Management and Administrative Services Agreement, which occurred September 29, 1997. The agreement also expressly contemplated that NovaCare and Gingras would enter into an Employment Agreement, and a Non-Competition Agreement. These were entered into on September 29, 1997 and September 30, 1997 respectively.

At about the same time as the buy-sell agreement, the Debtor and Gingras entered into an Assignment Agreement, dated as of September 30, 1997.[2] The Debtor's board of directors, by unanimous written consent to act without a meeting, assigned to Gingras "all rights, title and interest in the Earn-Out Payments, including full power and authority to collect, receive and give acquittance of any sum or sums due with respect to the Earn-Out Payments." The Debtor's board of Directors consists of Gingras, his wife Marbee Gingras, and his brother-in-law Richard Murray.[3] The agreement indicates that the assignment was made "as an inducement for [Gingras] to enter into the [Employment Agreement and Non-Competition Agreement], in lieu of any future compensation from [Coal Clinics]." One year later, on September 1, 1998, Coal

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[2] It should be noted that the actual date the assignment agreement was signed is disputed by the Trustee, therefore the Court is not making a finding as to the date the agreement was signed.

[3] Richard Gingras is the Debtor's registered agent, president and director. Marbee Gingras is an officer and director of the Debtor and owns 97.09% of the Debtor's stock. Richard Murray is a director and owns 2.91% of the Debtor's stock.

Clinics was put into an involuntary bankruptcy. At the time, an Earn-Out payment was coming due.

In view of the bankruptcy, NovaCare was uncomfortable paying these sums to Gingras, and instead wished to pay the monies over to the Trustee. This prompted Gingras, in December 1998, to file an adversary proceeding captioned Richard Gingras v. Susan L. Sowell, Trustee in Bankruptcy for Coal Clinics, Inc., 98-3170 ("Gingras-Sowell adversary"), seeking to prohibit the Trustee from accepting any Earn-Out Payments due to the Debtor under the buy-sell agreement.

In the Gingras-Sowell adversary the Trustee has now asserted counterclaims against Gingras under 11 U.S.C. § 547 and § 548, seeking to invalidate the assignment. If the Trustee prevails in these claims, the Earn-Out monies will inure to the bankruptcy estate. On December 23, 1998, this Court entered an order denying Gingras' request for a preliminary injunction and directing the Trustee to hold in trust any funds received from NovaCare pending resolution of the adversary.

Blocked in this effort, on December 22, 1998, Gingras submitted a Demand for Arbitration to the NHLA, seeking to enforce the Debtor's rights under its agreement with NovaCare. Gingras' arbitration demand asserts the following: that he, as the assignee of the Earn-Out Payments has suffered alleged damages as a result of NovaCare's (a) breach of its written contractual obligations to the Debtor under the buy-sell agreement; (b) breach of its written contractual obligations to the Debtor under the Management

Agreement; and (c) breach of alleged oral promises to the Debtor (i) to hire one additional professional for the Coal Clinics office, and (ii) to hire a marketing individual for the Charlotte region to promote Coal Clinics' services.

On March 9, 1999, NovaCare filed its Verified Motion for Preliminary Injunction in this action. NovaCare's motion seeks to enjoin and restrain Gingras from proceeding with arbitration until this Court first (a) resolves the Trustee's claims to avoid the Debtor's transfer of the Earn-Out Payments to Gingras under the assignment, and (b) resolves NovaCare's request for declaratory relief in this action. At the hearing, NovaCare indicated that a major concern prompting the injunction request was a fear of being held doubly liable, due to the uncertainty of who's cause of action Gingras is asserting: his own or the estate's. Although NovaCare doesn't caption its motion as such, it is essentially seeking an interpleader through its injunction request and its pay over of the initial Earn-Out Payment to the Trustee.

Gingras filed a response to NovaCare's motion on March 10, 1999. Gingras argues that this Court must accept the assignment as valid until it may be avoided by the Trustee, and until that time the right to seek arbitration belongs to Gingras. According to Gingras, if it should be determined that the Earn-Out Payments belong to the estate, the Trustee will be able to step into Gingras' shoes in the arbitration proceeding, and therefore NovaCare will suffer no irreparable harm.

DISCUSSION

The Argument Against Injunction

Gingras' primary argument at the hearing is that the right to pursue the Earn-Out Payments belongs to him until the determination of the avoidance action is complete, and that he should not be stayed from pursuing his rights under the arbitration clause of the contract with NovaCare. In support of this contention, he relies on Federal Deposit Ins. Corp. v. Hirsch, 980 F.2d 125, 131 (2d Cir. 1992), which holds that the definition of property of the estate does not cover property recovered pursuant to fraudulent transfer actions. According to Gingras, this means that even though the Trustee is seeking to avoid the assignment of the Earn-Out Payments, the assignment is not currently property of the estate, and therefore he may pursue his arbitration demand.

The Hirsch case is factually distinguishable from the case at hand. In the Hirsch case, it was the FDIC who was pursuing the outside litigation to recover a fraudulent transfer, under federal statutory authority given to the FDIC as a receiver.[4] In addition, in that case the FDIC's authority to pursue the outside litigation was not contested by the parties. Id. at 130. Rather, the trustee in the Hirsch case was only seeking to impose the automatic stay on

[4] The FDIC authority to pursue fraudulent transfers is found in 12 U.S.C. § 1821(d)(17) which provides that the FDIC may avoid transfers made within five years of date upon which the FDIC was appointed receiver and that the rights under this provision shall be superior to any rights of a trustee or any other party under title 11. Therefore, the power of the FDIC to pursue the fraudulent transfer trumps that of a bankruptcy trustee.

the FDIC under 11 U.S.C. § 362(a)(1), and he was granted that relief.

The present case differs from Hirsch in several respects. Here, the outside litigation that Gingras is seeking to pursue is not directed by a federal statute. Nor is it pursuant to an arms length transaction. Instead, it is based on a putative assignment agreement entered into and approved by Gingras, his wife and another relative. The Trustee does not agree that Gingras has the authority to pursue the action, and is instead seeking to invalidate the assignment. Given these differences, this Court finds guidance in the case of A.H. Robins v. Piccinin, 788 F.2d 994 (4^{th} Cir. 1986), rather than in Hirsch.

The Trustee's Avoidance Action

It is helpful to initially look at the nature of the action that the Trustee is pursuing. This helps to explain the interaction between the avoidance action and the Gingras-NovaCare arbitration proceeding. The Trustee's counterclaim in the Gingras-Sowell adversary proceeding seeks to avoid the assignment agreement under 11 U.S.C. § 547 and § 548. Section 547 allows the trustee to avoid preferences made to insiders when the transfer occurs between ninety days and one year before the date of filing of the petition. Section 548 allows the trustee to avoid any transfers that were made within one year of filing the petition and that were made with an intent to defraud other creditors. "Insider" is defined in section 101(31), and includes directors and officers of the debtor.

Gingras is clearly an insider of the Debtor, since he is both the president as well as a director.

If the Trustee wins the avoidance action, the Earn-Out Payments belong to the bankruptcy estate, as does the right to make the arbitration demand on NovaCare.

The *A. H. Robins* Case

The Fourth Circuit, in A. H. Robins Co., Inc. v. Piccinin, has outlined a bankruptcy court's jurisdiction to grant an injunction of suits in other courts against third parties when those suits relate to the bankruptcy case. In A. H. Robins, the Debtor moved for an injunction to restrain the prosecution of civil liability actions against its products liability insurance company. Prior to filing bankruptcy, the Debtor was inundated with lawsuits arising from the use of the Dalkon Shield contraceptive device. Once the Debtor filed for Chapter 11, the lawsuits against the company were stayed under Section 362 of the bankruptcy code. However, the stay provision did not automatically stop the lawsuits from going forward against the Debtor's liability insurance carrier. The Debtor's theory in asking for the injunction was that the debtor's products liability policy with the insurance company was an asset of the estate that would potentially be depleted while the debtor was reorganizing. The depletion of that policy would in turn frustrate the reorganization attempt.

The Fourth Circuit found four bases upon which the court could grant the injunction against the third party plaintiffs and defendants. The first two are found in 11 U.S.C. § 362, which "protects the debtor from an uncontrollable scramble for its assets in a number of uncoordinated proceedings in different courts." A. H. Robins, 788 F.2d at 998. The Court discusses both sections 362(a)(1) and (a)(3). The applicable provision in the present case is section 362(a)(3), which imposes the automatic stay against suits that involve any "act. . . to exercise control of property of the estate." 11 U.S.C. § 362(a)(3) (1998).

Property of the estate is defined in section 541 (a)(1). It provides that the bankruptcy estate is comprised of all legal or equitable interests of the debtor in property as of the commencement of the case, wherever located and by whomever held. 11 U.S.C. § 541(a) (1998). The Supreme Court has addressed this section, stating "[t]he scope of [541(a)(1)] is broad. . . it included all kinds of property including tangible or intangible property, causes of action and all other forms of property." United States v. Whiting Pools, Inc., 462 U.S. 198, 205 n.9, 103 S.Ct. 2309, 2313 n.9, 76 L.Ed.2d 515 (1983).

The Fourth Circuit held that any action in which the judgment may diminish the property of the estate is unquestionably subject to a stay under § 362(a)(3), accordingly actions related to the bankruptcy are also to be stayed. A. H. Robins, 788 F.2d at 1001-2.

The third ground the Fourth Circuit identified as a basis for imposing an injunction is 11 U.S.C. § 105, which provides that the bankruptcy court "may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." 11 U.S.C. § 105 (1998). According to the Fourth Circuit, this "empowers the bankruptcy court to enjoin parties other than the bankrupt" from commencing or continuing litigation. Id. at 1002 (quoting In re Otero Mills, Inc., 25 B.R. 1018, 1020 (D.N.M. 1982)).

This power includes actions related to a bankruptcy case. An action is related to bankruptcy if the outcome could alter the debtor's rights, liabilities, options or freedom of action and which in any way impacts upon the handling of the bankrupt estate. A. H. Robins, 788 F.2d at 1002 n.11 (quoting Pacor, Inc. v. Higgins, 743 F.2d 984, 994 (3d Cir. 1984)). The ability of the bankruptcy court to enjoin related actions that interfere with the administration of the estate exists in both liquidation and reorganization cases. Id. at 1003.

In order for the bankruptcy court to invoke its injunctive power, the court must find that a failure to enjoin the related action would affect the bankruptcy estate and would adversely or detrimentally influence and pressure the debtor through the third party. Id.

The fourth basis for the bankruptcy court's injunctive power discussed by the Fourth Circuit is the "inherent power of [bankruptcy] courts under their general equity powers and in the efficient management of the dockets to grant relief." A. H. Robins, 788 F.2d at 1003. The Court must make a finding similar to the one under section 105 in order to exercise this power. Here the court must engage in a balancing test and "justify the stay by clear and convincing circumstances outweighing potential harm to the party against whom it is to operate." Id.

ANALYSIS

In the present case, the cause of action that has been sent to the arbitrator does not clearly belong to either Gingras or the Trustee. The owner of the cause of action is the only proper party to proceed with the arbitration, especially since it is binding and will operate as a final adjudication under the buy-sell agreement's contractual terms. In this posture, it is more practical to decide who has the right to bring the cause of action initially, before proceeding with arbitration. If Gingras continues with the arbitration proceeding, and it is later determined that the right actually belongs to the Chapter 7 trustee, the damage to the estate could be great. The Trustee's and Gingras' goals in the litigation with NovaCare are not compatible, because their interests are not the same. Gingras is not only a putative party to the earn out rights, but has an ongoing employment agreement and non compete arrangement with NovaCare. It is safe to assume that Gingras will look after his own interests, while the Trustee acts in the best interests of the Debtor's estate and to maximize the benefit to the Debtor's creditors. Indeed, when the Court suggested at hearing that arbitration might be pursued by Gingras on behalf of himself and the estate, he declined for exactly this reason.

The Equitable Power of Injunction Basis

Gingras' position is that since an assignment was signed, it must be honored. The Court cannot automatically agree.

Transactions which allow insiders to claim equal or better standing than the creditors are subject to close scrutiny. In re Labelle Industries, 44 B.R. 760, 762 (Br. D.R.I. 1984); see also 4 Collier on Bankruptcy ¶ 510.05 (15^{th} ed. 1998). Insider transactions are subjected to rigorous scrutiny and when any of their dealings with the corporation are challenged, the burden is on the insider to show good faith in the transaction and also show its inherent fairness from the viewpoint of the corporation. Pepper v. Litton, 308 U.S. 295, 306, 60 S.Ct. 238, 245 (1939). Because insider transactions are subject to close scrutiny, the bankruptcy court does not have to give them in pari passu treatment with arm's length transactions. Id.

Gingras, as a director and officer, has entered into an assignment agreement with the Debtor in this case. The assignment agreement was ratified by a three member board of directors who were all related to each other and two of three of whom stood to benefit from the assignment. Prior to the buy-sell agreement with NovaCare, Gingras was earning a salary of approximately $75,000.00. In return for waiving rights to this salary, the Debtor gave Gingras the rights to NovaCare's Earn-Out payments, an amount that may total over one million dollars in the prescribed four-year period. Gingras says this was a fair exchange, but why it would be is in doubt. NovaCare had hired Gingras at his old salary so how he would have compensation claims against the Debtor is a mystery. Even if valid, swapping four years' salary ($300,000) for an earn out of more than one million dollars looks on its face unfair to the Debtor and its creditors. This is particularly true when that employment claim would only share in the other debts against a failing business's scarce assets. After all, the limited evidence available suggests this occurred at the same time as the company was not paying its creditors and was negotiating a sale of its assets.

Gingras asks this Court to allow him to proceed on what he argues is a facially valid assignment agreement. Typically, transactions that are sought to be avoided by the Trustee are treated as valid until such time as they are avoided. However, the agreement here is not an arms length transaction but is an insider transaction, and it is subject to a higher level of scrutiny. The disparity of what was given up and what appears to have been received by Gingras under the agreement, as well as the lack of any showing by Gingras that the transaction is fundamentally fair, makes this Court doubt that the agreement is valid.

Additionally, Gingras has failed to introduce any evidence convincing the Court that he will suffer irreparable harm if he is not allowed to proceed with the arbitration. There was no evidence introduced that Gingras is in any economic duress or that there is a time limit that may run on the right to demand arbitration. Even if Gingras was under economic duress, allowing the arbitration to proceed in the present posture does not necessarily guarantee a monetary recovery from NovaCare.

The true harm in allowing the arbitration to proceed is to the bankruptcy estate. Based on the allegations in the Trustee's counterclaim, the assignment that Gingras and the Debtor entered into appears to be a prima facie fraudulent transfer, diverting up to $500,000.00 a year from the Debtor to Gingras. Within one year of the assignment, the company was put into an involuntary bankruptcy by its creditors. Based on these allegations, the Court believes that the Trustee has a strong possibility of succeeding on the merits.

The fact that this is an insider transaction of doubtful validity, along with the finding of the possibility of irreparable harm to the estate, and the effects on NovaCare makes the undersigned believe it necessary to determine the owner of the claim against NovaCare, before proceeding with the arbitration itself. This Court's equitable powers will therefore preliminarily enjoin the arbitration proceeding.

The Section 362(a)(3) Basis

The arbitration is also subject to the automatic stay under section 362(a)(3) because it is an attempt by Gingras to control a cause of action that may be property of the bankruptcy estate. The Trustee's avoidance action constitutes an equitable interest in the Earn-Out Payments. Under the Supreme Court's view of property of the estate, as noted in Whiting Pools, this type of interest is clearly contemplated. The asset may be diminished if Gingras alone is allowed to proceed with the arbitration, and the automatic stay should be imposed until the avoidance action is adjudicated.

The Section 105 Basis

Under section 105, the Court must find that a failure to enjoin the arbitration will affect the bankruptcy estate and will detrimentally influence or pressure the Trustee. A finding of this nature is clear in the present case. Allowing Gingras to proceed with the arbitration, with the proviso that the Trustee would step into his shoes, takes away all of the Trustee's strategic power. It disallows the Trustee the ability to make decisions that will best benefit the Debtor's estate and creditors. An expedited determination of the owner of the claim against NovaCare is the best solution to these procedural problems, and under section 105 the Court finds that the arbitration should be enjoined.

The Expedited Procedure

The Court has already shortened the pleading time in the Gingras-Sowell adversary by order dated February 5, 1999. The initial pre-trial order was entered March 24, 1999, and any changes needed shall be made to expedite the avoidance claim as to the assignment agreement. The proceeding will be resolved in as short a time frame as possible, and upon that outcome, the arbitration proceeding against NovaCare will resume. There will be minimal delay, and at the end, all the parties will be aware of their rights and potential liabilities. The expedited process shall only apply to the avoidance actions that relate to the assignment agreement. All other actions in the Trustee's counterclaim will be tried as normally scheduled by this Court.

WHEREFORE, IT IS HEREBY ORDERED that NovaCare's preliminary injunction shall be **GRANTED** until such time as an expedited resolution of the avoidance actions in Adversary Case Number

98-3170 is had, as it relates to the Gingras-Coal Clinics, Inc. Assignment Agreement.

This the 29th day of March, 1999.

J. Craig Whitley
United States Bankruptcy Judge